FORTRESS PARTNERS

eMemo

TO: INVESTOR/MEMBERS, BANKERS AND FRIENDS
FROM: Jon Bruss
DATE: August-September 2022
SUBJECT: Where are the US Economy and Bank Stocks *Really* Going?

We've been told by the expert economists at the National Bureau of Economic Research (NBER) that should Gross Domestic Product (GDP) decline in value for two consecutive calendar quarters, the US Economy is in recession. We will seek to dispute that notion with this August-September *E*-Memo and show how bank stocks will benefit.

It is six decades since the halls of Marquette University were trod by this writer to earn a degree in economics—the so-called dismal science. I took courses in Macroeconomics Analysis andparticipated in extensive and intensive discussions on matters concerning the NBER. One professor challenged us to examine every well-worn maco-economic theory, including the NBER's cast-in-stone theories leading to the conclusion that two consecutive quarters of negative GDP doth a recession make. We were guided to challenge each element of NBER's "recession theory" and through that semester-long discussion and analysis, concluded that the inputs were not always what they were cracked up to be. The takeway for me was that the declaration of a recession after two consecutive quarters decline in GDP was not consistently reliable.

On Monday, August 29, 2022, Jon Hilsenrath of the Wall Street Journal wrote "A Different Take on the US Economy: Maybe It Isn't Really Shrinking," in which he points out that Gross Domestic Income (GDI), "an alternative to gross domestic product as a measure of output points to a stall instead of a recession." While, GDP should theoretically equal GDI, it doesn'tn't always because the two are measured using different data sets and different sources. Hilsenrath further notes that a chart provided by the US Commerce Department shows that the average of the two is actually above zero growth and GDI shows a greater gap above zero than GDP's gap below zero. While GDP declined at a 1.1% annual rate, GDI which measures among other things, corporate profits, wages and benefits, self-employment income, interest and rent, grew at a 1.6% annual rate. "Some economists look for a clearer picture by averaging GDP and GDI. That measure of output barely moved at all, rising at a 0.2% annual rate, adjusted for inflation over the first six months of the year."

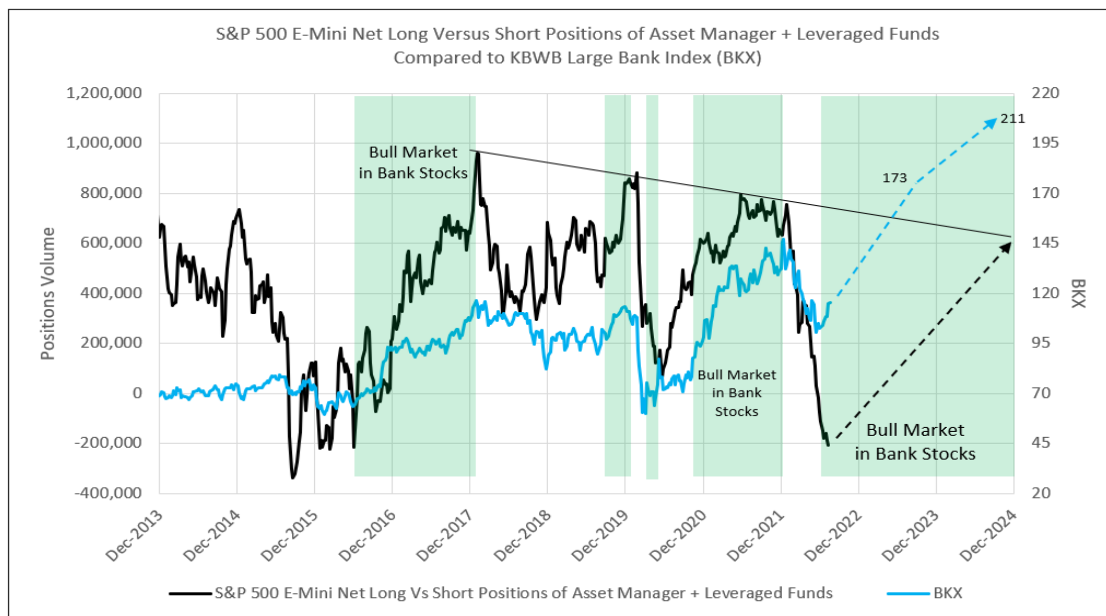
"'The economy is stagnating but its not declining', said Robert Gordon, a Northwestern University professor and longstanding member of a committee at the National Bureau of Economic Research which dates the beginning and end of recessions." Furthermore as economists look back to a study done in 2010 by a former Fed economist, Jeremy Nalewiak, they find that GDI may be a more reliable real-time gauge of activity than GDP, and they learned that GDP tends to be revised toward income measures over time. Hmmm. What does that mean for the "popular rule of thumb that recession is defined by two consecutive negative quarters of growth"? Simply that according to the 2010 study the GDP contraction may be revised away in the years ahead according to Hilsenrath.

But we knew all that, right? We know that the banking industry is healthy with strong capital ratios, little loan delinquency, accelerating growth in commercial lending and favorable lending rates. We see that in the banks we own and you see that in the banks you own or manage. Our fellow bank analyst and bank statistion, John Rickmeier, founder and president of IDC Financial Publishing notes this and more in his August 22, 2022 piece entitled "Defying Recession Fears, Bank Commercial Lending Accelerates". Its subtitle reads, "Favorable Lending Rates Creating a New Bull Market in Bank Stocks."

To support his view of commercial bank lending and the creation of a new bull market in bank stocks, Rickmeier first cites Ed Yardeni, President of Yardeni Research, in an August 14, 2022 article in the *Financial Times*. Yardeni, in analyzing Chairman Powell's comments from his July 27 press conference noted that Powell said the Fed funds rate is now "neutral" after raising the Fed funds rate twice at 75 basis points each to a range of 2.25% to 2.50%. While those remarks were well received, Powell's remarks last Friday (August 26) caused the Dow Jones to close down over 1,800 points from then through the end of August and down 13.29% for the year.

According to Yardeni, Powell may be right in his July 27 remarks when he notes that the European Central Bank and the Bank of Japan rates are still at or near zero resulting in the US dollar advancing 10% this year. Yardeni says this is the equivalent of 50 basis point rise in the Fed funds rate. Moreover, he points out that the Fed has just started its quantitative tightening program. The massive amount of asset sales—$1.14 *trillion* through August 2023 is equivalent to another 50-basis point rise in the Fed funds rate. So was Powell blowing smoke in the wide-open spaces of Wyoming last Friday? One could conclude that inflation is indeed neutral and should not be feared!

The KBW NASDAQ Bank Index (BKX) has declined 19.98% since December 31, 2021. That's oversold! Rickmeier says that the "oversold bear market provides opportunity for bank stocks to outperform in 2022 through 2024". Finally, he reiterates (and we agree): **"**favorable fundamentals for banks which include commercial loan growth, strong capital positions, low loan delinquency and rising rates, coupled with a controlled inflationary environment**"** (see Ed Yardeni's comments above—Fed's at neutral and John Rickmeier's chart below) "provide superior bank stock performance."



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